

***TAX AUDIT PRACTICE AND ITS SIGNIFICANCE IN
INCREASING REVENUE IN ETHIOPIA THE CASE OF
ADDIS ABABA CITY ADMINISTRATION***

**FOR THE PARTIAL FULFILLMENT OF
MSC.IN ACCOUNTING AND FINANCE**

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DECLARATION

I, Mesfin Gebeyehu declare that, this paper prepared for the partial fulfillment of the requirements for MSC. Degree in Accounting and Finance entitled "**Tax audit practice in Ethiopia and its significance in increasing revenue the case of Addis Ababa City Administration**" is prepared with my own effort. I have made it independently with the close advice and guidance of my advisor.

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Certification

This is to certify that Ato Mesfin Gebeyehu has carried out this research work on the topic entitled “**Tax audit practice in Ethiopia and its significance in increasing revenue the case of Addis Ababa City Administration**” under my supervision. This work is original in nature and it is sufficient for submission for the partial fulfillment for the award of MSc. in Accounting and Finance.

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**ADDIS ABABA UNIVERSITY
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Abbreviation:

AA:	Addis Ababa
AAA:	American Accounting Association
AICPA:	American Institute of Certified Public Accountants
BoFED:	Bureau of Finance and Economic Development
COBAC:	Committee on Basic Auditing Concepts
EFY	: Ethiopian Fiscal Year
ERP	: Economic Reform Program
FDRE:	Federal Democratic Republic of Ethiopia
GAO:	Government Accountability Office
GDP:	Gross Domestic Product
OECD:	Organization of Economic Cooperation and Development
HTT:	Hard to tax
IFAC:	International Federation of Accountants
INTOSAI:	International Organization of Supreme Audit Institutions
ISA:	International Standard on Auditing
IT:	Information Technology
SME:	Small and Medium Enterprises
SAI:	Supreme Audit Institutions
TOT:	Turn over tax
VAT:	Value Added Tax

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CHAPTER ONE

INTRODUCTION AND RESEARCH DESIGN

1.1. Introduction

Revenue is probably the most important part of the government and most of its plans and policies also depend on the amount of revenue collected. Government has also given priority in reducing the budget deficit through the mobilization of internal resources.

In the context of liberalization and globalization of the world economies, many governments have opened new investment areas to foreign investors. In order to meet these new challenges and to simplify tax administration, the Federal Democratic Republic of Ethiopia amended the tax laws with new provisions and procedures to assist the tax payers in complying with the self assessment process so as to reduce tax evasion and then to increase the revenue generation through tax.

Expanded domestic revenue base (especially taxation) offers a promise of greater autonomy in the future and a break from restrictive aid and loan conditionalities.

With this vision, recently, many poor countries have become preoccupied with improving tax systems. For instance, in the case of Ethiopia in an effort to increase

the government's domestic revenue the government replaced the sales tax with Value Added Tax (VAT) & Turn over Tax (TOT). In addition, the Ministry of Revenue was established giving autonomy to the government's revenue organ, and the tax system is computerized. Further more, the Federal Democratic Government of Ethiopia is trying to improve its tax administration capacity which encompasses tax audit as one of its component.

Tax audit is an extension of the "attest function" of the historical financial audit. It is the audit of an assessee's accounting and other documentary evidences for the preparation of current tax returns, as well as the supporting working statements, followed by an audit report giving the auditor's opinion about the degree of correspondence between the information contained in the tax return and the regulatory provisions of tax laws.

In other words, tax audit is an extension of the normal audit generally conducted for the purpose of expressing an opinion as to the fairness of the accounts examined by the auditor, and the certification of financial statements for tax purposes. It is meaningful if based on the knowledge of tax laws, similarities and dissimilarities between commercial accounting and tax accounting and reporting to the tax department, recognizing their requirements to enable the latter to compute taxable income. It includes what a tax official can look for when aiming to complete an assessment of tax. It covers also the disclosure of all significant accounting practices employed in the organization, a report on the financial accounts, i.e. the

balance sheet, profit and loss account and other related accounts and schedules which are part and parcel of the financial reports. Furthermore, information is required to compute the assessable income as well as to ensure that the compliance of the tax laws and regulations is proper.

1.2. Statement of the Problem

While the principal source of a government's revenue should be taxation, in many Sub-Saharan African countries this is often not the case. Many of the Sub-Saharan African countries rely on foreign sources of finance namely foreign loan and aid due to their poor tax administration capacity and collection ability.

There are various reasons why revenue administration reform may be needed in a country. First, while tax policy and tax laws create the potential for raising tax revenues, the actual amount of taxes flowing into the government treasury, to a large extent, depends on the efficiency and effectiveness of the revenue administration. Weaknesses in revenue administration lead to inadequate tax collections. Financing of the resulting budget deficit through borrowing or monetary expansion can cause an unsustainable increase in public debt and inflation, respectively.

In the alternative, revenue shortfalls shrink the budgetary resource envelope, thus, affecting the government's ability to implement its policies and programs and provide public services. Unexpected decline in revenue collections also cause

budget cuts that result in major inefficiencies in the public expenditure management.

Second, the quality of revenue administration influences the investment climate and private sector development. Firms considering investments are not only concerned about the formal tax system, but also about how the system works. A revenue administration that is perceived to be arbitrary or predatory discourages investment. Further, weaknesses in the enforcement capacity of the revenue administration put law-abiding firms at a competitive disadvantage, as their competitors in the informal sector are allowed to get away with tax evasion. This reduces incentives for businesses to join the formal private sector.

Third, taxes and customs administrations are possibly near the top of public-sector organizations with a high incidence of corruption. The cost of this corruption is high, both for the government and taxpayers. The government suffers major revenue leakages as dishonest revenue officials allow unjustified tax breaks to willing tax evaders. Honest taxpayers suffer as corruption in revenue administration leads to harassment, inflated assessments, high litigation costs and leniency towards non-compliant competitors. Any serious effort to reduce corruption in a country and improve governance, in all likelihood, has to involve reform of the revenue administration.

Finally, reform of the revenue administration that include efficient and effective tax audit may be needed to enable it to keep up with the increasing sophistication of business activity and tax evasion schemes. With globalization, goods and services are produced by taxable entities in multiple countries.

This presents vast opportunities for manipulating transactions to reduce the tax burden. The existence of tax havens, electronic financial transactions and the increasing use of the internet in commerce pose major challenges in enforcing the tax laws. Without a matching increase in the professional and technological capacity of the revenue administration, its chances of monitoring taxable activity and countering tax evasion are seriously reduced. For this reason tax audit plays an important role to increase the revenue administration capacity.

As tax audit is one of the tools of revenue administration, this paper focuses on its significance and practice in Ethiopia taking Addis Ababa City Administration as a case.

1.3. Objectives of the Study

The study has the following objectives:

- To trace out the basic concepts of tax audit along with the different methods of its implementations.
- To analyze the significance of tax audit in strengthening tax administration capacity.

- To analyze the role and significance of tax audit in increasing revenue
- To provide concrete suggestions to the issues relating to tax audit practice in Ethiopia based on the case study.

1.4. Significance of the Study

The study will provide feed back to tax payers and tax authority regarding the significance and application practice of tax audit. The study also contributes in evaluating the prevailing tax audit practice and in making some adjustments on the existing tax audit systems.

More over, it will provide constructive feedback about the efficiency and effectiveness of the existing tax audit practice in A.A City administration.

Finally, for those who are interested to make further study on the related issue may be used as indication.

1.5. Scope and Limitation of the Study

The study analyses the tax audit practice in Ethiopia with special reference of A.A City Administration. In particular tax audit practice category 'A' and category 'B' tax payers will be considered in the study. While studying the tax audit practice, the present study, considers only the practice and its application in A.A City Administration, so that the scope may be some how limited.

However, since the general guidelines, application procedures and practice are the same through out the country, it is supposed that the paper can fairly reveal the tax audit practice and its significance in increasing the revenue of the country.

Of course it may have some limitations with the conclusion to take it as country wide. The reason is that, there are some types of taxes which are not applicable in A.A City Administration, especially income from agriculture even if it is not subjected to audit.

1.6. Research Design and Methods

Once the research project is identified and defined clearly, the next step is to design the research method, because the research design provides guidelines for data collection.

As noted earlier, the aim of the paper is to identify the extent, efficiency and effectiveness of tax auditing in maximizing revenue generation. The focus of the paper is to obtain some qualitative and quantitative data that would facilitate a conclusion about the practice of tax audit system and its impact on revenue of the country.

1.6.1. Data Collection Methods

Data are the basic input to conduct meaningful research. In conducting the research the data that are going to be used are both primary and secondary data.

Among the different primary data collection methods questionnaires and personal interviews are the main that have been most usually applied in this research paper.

The questionnaire contains around ten open – ended which need further elaboration and suggestion by the respondent. Where as, the remaining closed – ended questions about tax audit application and its efficiency and effectiveness.

1.6.2. Questionnaire Design

Questionnaire design for tax audit surveys typically helps to extract information on the characteristics of the business, the time spent on each tax audit case by tax auditors, issues of tax evasion, and tax related malpractices by tax payers, fees paid to professional tax auditors; and any other related issues.

The questionnaires are designed to meet the following objectives:

- ❖ ***User friendliness***: The questions were kept short and language was as simple as possible to encourage legibility and maximize the response rate.

- ❖ **Comprehensiveness:** the number of questions was kept to a minimum to encourage responses. However, it was necessary to collect a large amount of relevant quantitative and qualitative data.
- ❖ **Attitudinal questions:** Tax auditors have been asked to respond on their attitudes towards the existing tax system and the significance of tax audit for the government as well as for the tax payer.
- ❖ **Respondents:** had an opportunity to add any comments that they feel were not covered in the survey, and to indicate the time that they had taken to complete the questionnaire.

Questionnaires are distributed for all the ten sub cities found in Addis Ababa two for each and nineteen questionnaires out of the total are returned. Around sixteen were more or less filled; the remaining three were partially fulfilled.

Secondary data are also collected from source documents, published materials, annual reports, magazines, research papers and internet.

1.6.3. Data Analysis

After data were collected, proper tools and techniques have been used for classification and analysis of data. The main tools that have been applied for classification of data are tables, charts and graphs. The analysis of data involves

computation of statistics such as ratios and percentage analysis methods are applied.

The analysis is based on the countries revenue performance as compared to other African countries, its budgeted revenues and tax audit practice in A.A City Administration using the various types of taxes applied through out the country.

1.7. Arrangements of Chapters

The objective of the present study is to provide evidence regarding the tax audit practice and its role in increasing revenue of the government. For this purpose the study has been arranged in to :

- I. Introduction and design of the study
- II. Review Of Related Literatures
- III. Analysis and Discussions of the Study
- IV. Conclusions of the study and recommendations

CHAPTER TWO

REVIEW OF RELATED LITERATURE

2.1. Meaning of tax audit

An audit is the independent examination of financial statements of related financial information of an entity, whether profit oriented or not, and irrespective of its size, or legal form, when such an examination is conducted with a view to expressing an opinion thereon. ¹

The American Accounting Association (AAA) has provided a broader definition of audit which refers to:

... a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users. ²

In a narrower sense, audit is an “attestation communication” because it presents the auditor’s opinion or judgment concerning the degree of correspondence between accounting information and established criteria.

¹ IFAC, 1993, p. 10

² AAA, 1973, p. 2

To the tax administration, tax audit refers to the examination of tax returns by concerned tax officials primarily with respect to checking as to timely arrival, inclusion of all required forms and attachments, and arithmetical accuracy. This may be called internal tax audit.

A tax audit is one of the most sensitive contacts between the taxpayer and a revenue body. The presence of an auditor in a taxpayer's private dwelling or business premises, coupled with the exploration of private and business issues and the gathering of information from taxpayers' books and records, or just the disruption of day-to-day workflow, represents a burden on the taxpayer and may be seen by some as an unwarranted intrusion into their affairs. Notwithstanding this, tax audits remain the only effective method for ascertaining additional facts or verifying provided information.

The tax audit function plays a critical role in the administration of tax laws in all countries. In addition to their primary role of detecting and deterring non-compliance, tax auditors are often required to interpret complex laws, carry out intensive examinations of taxpayers' books and records, while through their numerous interactions with taxpayers operating very much as the "public face" of a revenue body. These factors, as well as the absolute size of the audit function in most revenues bodies, provide a strong case for all revenue bodies paying close attention to the overall management of the tax audit function.

Historically, the audit function conducted by public accountants has been associated with this activity of attesting to financial statements.

Tax audit (expected to be performed by public accountants) can be thought of as an extension of this “attest function”. For tax purpose, one assessee is liable to file a return to the concerned assessing officer with supporting documents sometimes required by tax law for simultaneous submission with the return. The assessee is sometimes called for by the assessing officer under the tax law for producing the same. In this context, the question of tax audit may arise. And “tax audit” means to audit an assessee’s accounting and other documentary evidences to prepare the correct tax return as well as to prepare the statements showing the detailed computational working for different heads of income or items in tax return and other required evidential statements regarding allowances and disallowance for deductions and all these are to be followed by an audit report giving the auditor’s opinion about the degree of correspondence between the information content in the tax return and the regulatory provisions of the existing tax laws.³

Thus, tax audit comprises the following:

- Accounts and other evidences are required to comply with the “tax basis of accounting”, i.e. as per requirement of tax laws;

³ AAA, 1973, p. 14

- Preparation of tax return, statement of computational working for items in the return and statements containing particulars of allowances and disallowance for deduction;
- Giving audit report portraying the attest function whether the tax return and statements have been fairly prepared as per the regulatory requirement of tax laws.⁴

When we think about who does tax audits, we first think of a public inspector, a civil servant, integrated in a public organization or agency of the government.

Nevertheless, in the field of private financial statements audit, the audit must comprise all the economic-financial operations, including the taxes-originated ones, and the auditors opinion must also include whether the taxpayer has correctly assessed tax liability.

For instance, according to Kamal Gupta&Ashok Arora, in India ,the income tax Act,1961 ,provides for compulsory audit of the accounts of certain income tax assessee's (i.e. persons liable to pay income tax)whose turn over exceed the specified limits. It was also practiced for some years in Ethiopia but left after the 1997 E.C. election. The objective of such audit is to assist tax authorities in making the correct income tax assessment of the assessee's concerned. The tax auditor has to specifically report on certain transactions which have an impact on the income

⁴ . www.jstor.org, The Accounting review :VOL,48

tax liability of the assessee concerned and are, thus important to the tax authorities.⁵

2.2. Audit of government revenues

In recognition of the importance of an efficient revenue collection system for mobilizing the budgetary resources of the government, the need to establish revenue audit as a specialized and independent domain has been engaging the attention of the Supreme Audit Institutions for quite some time. The International Congress of International Organization of Supreme Audit Institutions (INTOSAI) held at Rio de Janeiro, Brazil in May, 1959 recommended that:

- ✚ Supreme Audit Institutions (SAI) ought to exercise the broadest possible supervision of revenues.
- ✚ Supervision should not be limited to the checking of collection of revenues in line with the accounts rendered by the collectors but, wherever possible, a check should be made to see whether or not tax payments were in line with legislation.
- ✚ SAIs should ascertain whether there has been negligence in the matter of collections or exaggeration in the estimates.
- ✚ The SAIs ought to be equipped to carry out their duties, especially as regards supervision of revenues, with mechanized accounting and statistical services.

⁵ Kamal Gupta, (1992,) contemporary auditing, 4th ed, Tata McGraw hill publishing company limited.

The concept of tax audit was a sub-theme in the Third International Seminar of ASOSAI held at Bali, Indonesia in June 1988. The following guidelines were recommended in the area of tax audit.

(a) Audit mandate: SAIs should seek clear and specific legal authority for undertaking comprehensive tax audits in conformity with the relevant provisions of the Lima Declarations on Auditing Precepts.

(b) Audit of individual tax assessments: It is important that individual tax files are examined to evaluate the adequacy of the system and procedures of tax assessment and collection. As the examination of all tax files is neither feasible nor necessary, best results may be obtained while concentrating on high value and risk areas. Selective auditing of business income cases rather than salary assessment, investigations of reported evasions and use of suitable statistical sampling techniques in the review of files are preferred practices. Data and information on tax payers collected by the tax authority may be verified against other independent sources available.

(c) Interpretation of tax laws: SAIs should scrutinize the rules, regulations and notifications issued by the executive agencies under the tax statutes.

(d) Scrutiny of decisions of tax authorities: Where quasi-judicial and discretionary powers are vested in the tax officials, any decisions taken in the exercise of such powers should be scrutinized in audit.

(e) Audit methodology: Audit should be mainly system based and the objective should be to discover loopholes, lacunae and deficiencies not only in tax

administration but also in tax laws. Adequate procedures for identifying and dealing with tax avoidance arising from deficiencies in laws could be considered so that remedial action including amendments to the laws could be taken promptly.

(f) Socio-Economic implication of taxation. The social and economic goals proposed to be achieved through tax concession and relief should be reviewed in audit.

(g) Reporting on the results of tax audit: Having regard to personal privacy considerations, it is imperative that confidentiality be maintained in reporting individual assessments in the audit reports.

(h) Training of tax auditors: Tax audit is a specialization which requires thorough knowledge of the relevant laws and regulations. SAIs should provide intensive and frequent training for tax auditors taking advantage of the training facilities available in their local tax department's training institutions as well as those in other SAIs.

2.3. The roles of the taxpayer audit program

The tax audit program of a revenue body performs a number of important roles that effectively carried out & can make a significant contribution to improved administration of the tax system.

These roles are described briefly hereunder:

- **Promote voluntary compliance:** The primary role of the audit program is to promote voluntary compliance by taxpayers with the tax laws. It seeks to achieve this by reminding taxpayers of the risks of noncompliance and by

engendering confidence in the broader community that serious abuses of the tax law will be detected and appropriately penalized.

- **Detect non-compliance at the individual taxpayer level:** By concentrating on major areas of risk (e.g. unreported cash income) and those individual taxpayers most likely to be evading their responsibilities, audits may bring to light significant understatements of tax liabilities, and additional tax revenue collections.
- **Gather information on the “health” of the tax system** (including patterns of taxpayers’ compliance behavior): The results of normal audit activity may provide information on the general well-being of the tax system. Audits conducted on a random basis can assist overall revenue administration by gathering critical information required to form judgments on overall levels of tax compliance, that over time can be used to identify trends in overall organizational effectiveness and to gather more precise information that can be used to inform decision-making on future compliance improvement strategies, to refine automated risk-based case selection processes, and even support changes to tax legislation.
- **Gather intelligence:** Audits may bring to light information on evasion and avoidance schemes involving large numbers of taxpayers that can be used to increase major counter-abuse projects.
- **Educate taxpayers:** Audits can assist clarify the application of the law for individual taxpayers and to identify improvements required to recordkeeping and thus may contribute to improved compliance by taxpayers in the future.

- **Identify areas of the law that require clarification:** Audits may bring to light areas of the tax law that are causing confusion and problems to large numbers of taxpayers and thus require further efforts by the revenue body to clarify the laws' requirements and/or to better educate taxpayers on what they must do to comply into the future.

Given the broad range of roles to be performed a revenue body's audit program typically entails the largest allocation of a revenue body's total staff resources.

From this perspective alone, the audit program represents a sizeable strategic investment that dictates the need for sound management policies and practices.

2.4. Government Revenues scope and extent

As mentioned earlier, government revenues are sourced from various tax and non-tax receipts. The country papers bring out the dimensions of these two sources which in turn influence the areas of audit priority. These are tax and non tax revenues. Government revenues are largely dependent on taxes legislated through various tax statutes. However, the spread of the two sources, viz. tax and non-tax revenues, varies from country to country.⁶

⁶ Forum on Tax Administration's Compliance Sub-group, Strengthening Tax Audit Capabilities: General Principles and Approaches, 16 October 2006

The scope of audit activities varies across countries, in part as a result of the system of assessment in place. There are two generally accepted systems of tax assessment applied world wide (administrative assessment and self assessment)

In around half of OECD countries, administrative assessment is employed to varying degrees in the administration of personal income tax and corporate profits/income tax. All countries administer VAT under self assessment principles.

Assessment systems operate on the principle that all tax returns should be subject to a degree of technical scrutiny before a formal assessment is sent to the taxpayer.

In practice, however, much of the scrutiny previously undertaken by technical staff has been replaced in many countries by the use of automated screening techniques to identify returns requiring scrutiny before a formal assessment is issued. To the extent that there is some level of scrutiny carried out by technical officers, it ranges in practice from a very cursory examination of some tax returns to a more in-depth examination where further inquiries may be made with taxpayers (sometimes by correspondence) before a formal assessment is issued. Even countries that operate administrative assessment regimes complement these arrangements with a formal program of post-assessment audits. However, in practice such programs tend to be conducted on a smaller scale than is the case in countries only applying self-assessment principles.

In countries where self-assessment principles are applied, returns are typically accepted as filed in the first instance (with the exception of returns containing

mathematical errors or clearly erroneous deductions) and, for income tax, a formal assessment/ notice confirming/advising the tax liability is sent to the taxpayer before any inquiry. A sample of returns is selected for post-assessment audit, generally applying computer-based risk selection techniques and/or manual screening processes. Large scale matching programs may also be mounted on a post –assessment basis for the major categories of income (i.e. wages, interest, and dividends).⁷

Since virtually all tax returns are accepted as filed without technical scrutiny when applying self-assessment principles, it is essential for the system to be supported by a reliable automated audit case selection system using risk-based screening techniques. Typically, such systems are developed using risk-based criteria derived from analyses of completed audit cases and are regularly updated to take account of the results of audit activities and to reflect important changes in the behavioral patterns of taxpayers. Examples of risk identification models and approaches are described in the companion note ‘Audit Case Selection.

As systems of administrative assessment and self-assessment have evolved over time in many countries there is something of a fine-line in practice between their features and relative efficacy.

⁷ Forum on Tax Administration’s Compliance Sub-group, Strengthening Tax Audit Capabilities: General Principles and Approaches, 16 October 2006

According to the Ethiopian Federal Inland Revenue Authority's tax assessment and audit manual, an assessment is basically an initial review by tax official of the tax declarations and information provided by tax payer and a verification of the mathematical and technical accuracy of the declared tax liability shortly after the submission of the declaration. The initial review also includes the application of various risk criteria to determine possible tax underpayments and the subsequent selection for tax audit.

An audit on the other hand, is the conduct by audit staff of appropriate verification of selected tax payers declared tax liabilities. This can include a review of tax payer's systems, books of account and other related information. It may include cross checks of tax payer's records with those of tax payer's suppliers or with other source of information such as the custom authorities or other government departments and agencies.

2.5. Key audit characteristics

Compliance regimes operate within the unique legal, cultural and administrative background of individual member countries. Nevertheless, there are a number of common pre-requisite features and requirements that need to be in place to ensure a good level of effectiveness and efficiency from audit activities and to support continuous improvement. They are:

- A comprehensive legal framework, including an appropriate regime of sanctions.
- Well-defined organizational and management processes, including a comprehensive performance measurement framework.
- Well-defined audit techniques and adequate support arrangements; and.
- Adequate human resource management and development programs.

2.6. Need for tax audit

Four conditions tend to create the demand for the independent performance of the audit or attest function. They are as follows:

- Conflict of interests between those who prepare accounting information reports and those who use them;
- Consequence of information to users while using them in decision-making;
- Complexity of subject matter and audit process; and
- Remoteness of users from subject matter and preparer.⁸

When audit function is extended to tax, the above-mentioned four conditions are also required to be satisfied. Here, the preparer of income tax return and relevant information (the assessee) has the conflicting relationship in terms of financial

⁸ AAA, 1973

interest with his counterpart user or evaluator of the return (the assessing officer). Because, manipulated information in the tax return may reduce the tax liability.

Second, use of the tax return, assumed to be correct and complete, may have serious consequence on Government fiscal estimation and collection thereof. As a result, all the budgetary appropriations may stand for nothing but a baseless imagination.

Third, both financial accounting and tax accounting are recognized as a much complex discipline due to technicalities and their distinct characteristics of difficulties.

Finally, between the preparer of the return and the information therein (by the assessee) and the assessing officer, there exists a wall of remoteness though the latter can call for any additional information from the former to be satisfied with the completeness and correctness of the information provided. But sometimes this may not be possible due to time and cost constraints and some other reasonable causes. In this case, the tax authority can apply his best judgment, which may not be the expression of the reality and thus both the parties, the Government and the assessee may be affected by under- or over-charging of tax. Therefore, all the conditions creating the demand for audit with respect to tax can be found to be satisfied.

Besides, the Committee on Basic Auditing Concepts (COBAC), suggested that the subject matter of any extension of the audit function must have the following attributes:⁹

- The subject matter has to be susceptible to the deduction of evidential assertions. Such assertions have to be both quantifiable and verifiable;
- There has to be an information system to record the actions, event or results thereof; preferably adequate internal controls have also to be in operation; and
- Consensus should exist on the established criteria against which the information prepared from the subject matter can be evaluated.

Each of the attributes stated above is essential. Two additional conditions are also needed. They are: auditor's competence and summarization of findings in a report.

The COBAC of AAA has recognized that extension of the attest function to the audit of income tax return appears to satisfy all the attributes stated above. The subject matter allows the deduction of evidential assertions, which are verifiable as well as quantifiable. Tax law requires the maintenance of an "information system" adequate for recording the actions and events, and the law also serves as a criterion for evaluating the subject matter information.¹⁰

⁹ Committee on Basic Auditing Concepts (COBAC)

¹⁰ COBAC

The International Federation of Accountants (IFAC) Ethics Committee, in the “Code of Ethics for Professional Accountants” has defined “professional service” as “any service requiring accountancy or related skills performed by a professional accountant including accounting, auditing, taxation, management consulting and financial management services”. Hence, an auditor must be competent first in accounting, inevitably in auditing, as well as thereafter in taxation. ¹¹

Introduction of tax audit by qualified professional accountants is indeed the esteemed recognition of their specialized competence. The real benefit from compulsory tax audit, if legally enforced, is that the audit will ensure maintenance of proper books of accounts and other records. The growing accounting habit thus developed will enable creation of a transparency of the in the middle of grey area between assumed income and reported income. Thus, tax evasion will be markedly curbed through checking the fraudulent practices concerning colluded accounts.

Other arguments in favor of tax audit include: tax return with added credibility and accompanied by tax audit reports as well as necessary supporting statements can reliably be presented before the authority facilitating tax administration, relieving assessing officers from carrying out routine verifications, and attending to more important investigation aspects of assessment cases through utilization of the saved time.

¹¹ The International Federation of Accountants (IFAC) Ethics Committee, in the “Code of Ethics for Professional Accountants”

2.7. Types of Tax audits

Audits can vary in their scope and the level of intensity to which they are conducted. For this reason, various terminologies have evolved to describe different types of audit activity:¹²

2.7.1. Full audits – The scope of a full audit is all-encompassing. It typically entails a comprehensive examination of all information relevant to the calculation of a taxpayer's tax liability for a given period. The objective is to determine the correct tax liability for a tax return as a whole. In some countries full audits are carried out as part of random audit programs that are used to gather data on the extent, nature and specific features of tax compliance risks, for compliance research purposes and/or the development of computerized audit selection formulae. Given their broad scope, full audits are typically costly to undertake a substantial program of full audits will require considerable resources and reduce the rate coverage of taxpayers that could otherwise be achieved by a more varied mix of audit types.

¹² Forum on Tax Administration's Compliance Sub-group, Strengthening Tax Audit Capabilities: General Principles and Approaches, 16 October 2006

2.7.2. Limited scope audits – Limited scope audits are confined to specific issues on the tax return and/or a particular tax scheme arrangement employed by the taxpayer. The objective is to examine key potential risk areas of noncompliance.

These audits consume relatively fewer resources than full audits and allow for an increased coverage of the taxpayer population.

2.7.3. Single issue audits – Single issue audits are confined to one item of potential non-compliance that may be apparent from examination of a taxpayer's return. Given their narrow scope, single issue audits typically take less time to perform and can be used to review large numbers of taxpayers involved in similar schemes to conceal non-compliance.

In practice, the scope and nature of any audit activity undertaken for a particular taxpayer will depend on the available evidence pointing to the likely risks of non-compliance and a taxpayer's prior history. Extensive audit inquiries may also be justified simply because a taxpayer's financial and /or business activities are unusually complex.

Periods under examination: Audits can focus on one financial year or accounting period, or be extended to cover multiple fiscal periods. An audit can focus on specific parts of the taxpayer's activities (such as sales, goods in stock etc), specific incidents or transactions or activities (such as those carried out in a branch or subsidiary), or specific tax obligations. An audit can vary in its level of detail.

Sometimes the taxpayer's affairs are examined in detail and in other situations, subject to the level of risk perceived, merely superficially.

2.8. Resources for the tax audit function

Revenue bodies typically have at their disposal a finite level of resources to conduct the day to day business of revenue administration. Given the many tasks to be performed and the inevitable decisions that must be made on priorities, a process is required to determine how those resources are to be allocated. In some member countries, revenue bodies have relatively limited discretion as to how staff resources are to be spread across the various areas of work, while in others broad discretion is given to senior management on how resources are to be allocated.

Regardless of how the overall budget of resources for audit work is arrived at, a key issue for the audit function is how those resources will be spread over the various segments of taxpayers. Determining how resources might best be allocated is a key element of a revenue body's strategy for compliance improvement and is dealt with in the following section.¹³

The significance of the roles played by the taxpayer audit function, as described above is evidenced in part by the relatively large proportion of staff resources

¹³ Forum on Tax Administration's Compliance Sub-group

devoted to this function. In many member countries, the proportion of the revenue body's overall staff resources devoted to audit and other verification activities exceeds over 30%.¹⁴

2.9. Location of audits

Tax audits can be conducted in different locations. Sometimes there is a need to carry out the audit at a taxpayer's business premises. In other situations, the books and records required to complete an audit can be collected by, or sent to, the revenue body and the audit work performed in the office. Tax audits can be categorized as 'field audits' or 'office or desk audits' on this basis.

Given that audits can vary in terms of their scope and intensity revenue bodies should have a clear policy on the types (and numbers) of audits to be conducted, and the circumstances in which specific types of audits are to be carried out, so that audit officials (including managers) understand what is expected of them.

2.10. Approaches& standards of Tax Audit

In conducting a tax audit the audit should apply the generally accepted practices of auditing as one would do in the case of other audits, e.g. an audit of a company

¹⁴ Tax Administration in OECD and Selected Nonmember Countries: Comparative Information Series (2006))

under the companies act. The generally accepted auditing practices are communicated in the various pronouncements of the respective country.

The auditor should get the financial statements as well as the statement of particulars authenticated by the assessed before he verifies them.

The auditor can apply the technique of selective verification (statistical sampling/ test-checking), depending on his evaluation of the internal control system prevalent in the entity under audit and the materiality of transactions.

In conducting the audit the auditor should keep in mind that the basic objective behind is to assist the authorities in assessing the collect income of the assessed.

For conducting the tax audit effectively an auditor needs to develop an approach which is a synthesis of taxation laws and auditing principles. The nature of tax audit is such that an auditor has to rely on various legal pronouncements in the field of taxation.¹⁵

2.11. The efficiency and effectiveness Tax audit

Audit effectiveness was measured by examining the amount of evidence selected for examination in relation to the total available evidence and an optimal level of evidence. Audit efficiency was then defined as audit effectiveness per unit of time by

¹⁵ Tax Administration in OECD and Selected Nonmember Countries: Comparative Information Series (2006))

taking the audit effectiveness measure divided by minutes spent on the task. The key findings were that time pressure (manipulated by four levels of a time budget for the task) affected performance only at the extremes, with the highest time pressure group performing more efficiently than the auditors in the lowest time pressure group. Efficiency was also affected by audit program structure, with high structure (more detailed audit procedures listed) being associated with increased efficiency.¹⁶

Apostolou et al. (1993) defined audit efficiency as the ability to meet the budget and operationalized it as the percentage deviation between actual and budgeted hours. This research examined the effect of leader behavior on audit efficiency. Two leader behaviors—(1) facilitating cooperation and teamwork and (2) administering discipline—resulted in increased audit efficiency. On the other hand, showing consideration contributed to reduced audit efficiency.¹⁷

In addition in an economic sense, the concept of efficiency is rooted in the ideas of minimization of inputs, absence of waste, and least cost production methods. Auditing practitioners tend to define efficiency as accomplishing the audit task in less time thereby increasing profitability.¹⁸

¹⁶ International Journal of Finance, (vol. **3**: 121–133 (1999)

¹⁷ Apostolou et al. (1993)

¹⁸ Hollingshead, 1996 Pillars of Integrity: The Importance of Supreme Audit Institutions in Curbing Corruption
Kenneth M. Dye and Rick Stapenhurst, The Economic Development Institute of the World Bank 1998

The efficient and effective conduct of audit activities requires that a revenue body's audit and investigation staff have appropriate powers of access to information held by the taxpayer and other parties so that taxpayers liabilities reported in their returns can be properly verified or, in the absence of returns, be accurately established. There should also be an appropriate regime of sanctions to punish and deter non-compliance.

For these reasons, revenue bodies require a set of powers and sanctions in the legal framework supporting the conduct of tax administration activities that includes the provision of adequate powers for obtaining information and an appropriate regime of sanctions covering the various offences that may arise. In practice, this legal framework may be set out separately in the laws governing each tax administered or, preferably for ease of legislative maintenance, in a single comprehensive law on tax administration that provides a common set of provisions covering all taxes.

In the US, an official form titled 'Cost Benefit Analysis' (Review of Cost Effectiveness of Investigations) is used to measure the cost benefit of continuing an audit. The form is being prepared at a predetermined stopping point in the audit (such as when 60 hours have been expended by the auditor). The form calculates cost benefit by assigning dollar values for the auditor's hourly labour costs and multiplying the cost by the hours projected to complete the audit. The auditor's total labor dollar cost is matched against the projected revenue anticipated (benefit

of continuance). A negative cost benefit analysis may result in the early termination of the audit.¹⁹

Collectibles is another factor for possible consideration. Some countries use collectibility as a pre-contact consideration and other countries reported that it could become a factor during the course of the audit if bankruptcy were imminent. The collectibility concept implies that a taxpayer's inability to pay a future proposed tax assessment would be sufficient basis for not conducting the audit.

Those administrations that do not use this concept report that collectibility is a secondary objective and should not diminish the primary objective of a correct assessment of tax liability. In addition, the limitation of collectibility considerations to the current tax period may not provide a complete financial picture for the taxpayer as it excludes consideration of future payment potential.

2.12. Significance of Tax audit in fighting corruption

Simply defined, corruption is the abuse of public power for personal gain or for the benefit of a group to which one owes loyalty. It occurs at the intersection of public and private sectors, when public office is abused by an official accepting, soliciting,

¹⁹ Hollingshead, 1996

or obtains by threat a bribe. Klitgaard (1996) has developed a simple model to explain the dynamics of corruption:²⁰

$$C \text{ (Corruption)} = M \text{ (Monopoly Power)} + D \text{ (discretion)} - A \text{ (Accountability)}$$

In other words, the extent of corruption depends on the amount of monopoly power and discretionary power that an official exercises. Monopoly power can be large in highly regulated economies; discretionary power is often large in developing countries and transition economies where administrative rules and regulations are often poorly defined. And finally, accountability may also be weak, either as a result of poorly defined ethical standards of public service, weak administrative and financial systems and ineffective watchdog agencies. Tax is one of the most exposed issues for corruption since it is carried out by the interaction of the tax payer and the tax auditor (official).

²⁰ Klitgaard (1996)

CHAPTER THREE

Analysis and Discussions of the Study

This chapter gives an overview of the Ethiopian tax audit practice with the special reference to Addis Ababa City and discusses the tax administration plus the challenges in tax collection faced by the country using Addis Ababa City as a model. The chapter discusses the ways how the Ethiopian government finances its activities, the revenue composition of the country as well as Addis Ababa City revenue agency tax audit practice and administration. The chapter further discusses the different related issues of tax audit so as to increase the revenue performance including with performance of tax audit and assessment activities.

3.1. Historical back ground

Tax in Ethiopia is as old as the country it self. All kings, leaders and land lords of ancient time have levied different types of taxes for various purposes. During those times the tax that was levied and collected all-most all in kind was spent for military purposes. Traditional taxes were paid in kind ,however taxes in the form of money has become applied in 19th and 20th century due to the circulation of money and modernization of government policies.

How ever, the modern tax system has been started during Emperor Hailesselasie(1942). To reach the current stage the Ethiopian tax has passed different stages even on wards from the Imperial period. According to the new constitution of Ethiopia adopted in November 1994, the federal democratic republic of Ethiopia would comprise a federal state and member states in which both organs shall have their respective, legislative, executive and judicial powers. All financial requirements necessary to carry out duties and responsibilities that have been given to the federal government and the regional state are envisaged to be covered by the respective organs and the sharing of revenue between the federal government and regional states follow the arrangements of the powers of the government.

Governments have several options at hand to finance their activities and pursue their fiscal policy. These options include the imposition of taxes and the generation of non-tax revenues through fees, levies, cost recovery and user charges, property and investment income, domestic and foreign borrowing (including loans from multilateral institutions), the sale of government assets (including the sale of public enterprises) , domestic and foreign grants. In most countries, conventionally defined legal taxes and levies constitute a significant proportion of GDP and finance a major part of government expenditure. It is therefore essential that tax systems be and at the lower levels of bureaucracy.

These levies also form a part of the burden of taxation and have socio-reallocation o form a part of the burden of taxation and have socio-reallocation efficiency,

efficiency, equity, administration and compliance costs.

However, in many countries, in addition to legally imposed taxes there are also arbitrary and irregular tax-like levies imposed by the authorities. These levies are a part of a larger phenomenon involving the need to make extra payments when interacting with government officials in many countries, particularly at the economic consequences. Nevertheless, these irregular payments are not captured in the traditional economic databases, including that involving government finance. When such irregular levies arise in-lieu of legally imposed taxes, the tax revenue collection will fall below what can be collected on objective grounds.

3.2. The Current Tax Administration System in Ethiopia

Taxation policy of a government generally seeks to apply the following desirable fiscal principles:-

- ❖ The subjects of every State ought to contribute to the support of the Government as nearly as possible in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the State. The observation or neglect of this saying reflects what is called the equality or inequality of taxation.
- ❖ The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be

paid, ought all to be clear and plain to the contributor, and to every other person.

- ❖ Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.
- ❖ Further more, every tax ought to be so affected as both to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State.

Ethiopia has implemented Economic Reform Program (ERP) since 1992/93 with the support of World Bank, International Monetary Fund, foreign governments and other multilateral institutions. Since then as a part of ERP, the government has taken tax policy measures. The tax reform Program has got momentum in 1999 when the "Revenue Board" scaled up to the a level of Ministry " Ministry of Revenue" and the reform expanded from tax policy measures to Administrative reform.

The Government of Ethiopia is modernizing the tax and custom administration by overhauling the legislations and improving administration. The reform measures are intended to encourage trade, investment and hence development; broadening the tax base and increase Government revenues to support social programs and alleviate poverty; strengthen the enforcement capacity of the tax and customs authorities; and promoting equity in the tax system.

Tax administration reform includes the proper registration of taxpayers, assessing taxable income and timely collecting of the assessed tax. An efficient and proper tax administration requires the prevalence of clear and transparent rules and regulations.

Tax laws and regulations should minimize discretionary powers of tax collectors but give sufficient enforcement power to them. This requires periodic inventory and revision of all existing rules and regulations. The presence of an efficient and modern tax revenue collecting institutions equipped with capable employees and new technology is equally important. Despite considerable achievements in reducing tax and tariff rates, rationalizing domestic sales and excise taxes, the revenue mobilization effort needs further actions both in policy and administrative aspects.

Table3.1 The Share Of Domestic Indirect Taxes From Total Revenue For Selected Countries

N o	Country	Direct tax	Indirect Taxes			Non- tax Reve nue
			Total indirect tax	Domestic Ind. Taxes	Foreign Trade tax	
1	Greece	37.83	53.51	53.43	.08	8.66
2	Turkey	32.09	45.69	42.69	3.01	19.48
3	Colombia	37.23	50.00	41.16	8.41	12.43
4	Kenya	30.59	56.73	41.53	15.2	11.80
5	Morocco	28.85	55.32	39.31	16.01	13.46
6	South Africa	55.20	37.18	35.92	1.27	5.95
7	Ghana	16.77	30.65	33.89	26.76	22.57
8	Chad	26.69	49.02	33.73	15.29	21.81
9	Israel	52.70	33.64	33.20	0.44	13.49
10	Korea	44.62	38.79	32.57	6.22	12.11
11	Gambia	14.74	74.45	32.41	42.04	5.93
12	Uruguay	44.94	35.67	31.89	3.78	7.02
13	Pakistan	16.14	55.14	31.86	23.28	28.73
14	Sweden	56.58	29.88	29.29	0.59	12.03
15	India	21.47	51.60	28.09	23.51	23.01
16	Mauritius	25.02	60.40	26.98	33.42	14.49
17	Zimbabwe	46.91	41.73	22.91	18.82	10.34
18	Cameron	19.65	46.07	22.51	23.56	28.78
19	Spain	69.51	22.46	22.43	0.03	8.34
20	Tunisia	31.74	48.57	21.66	26.92	16.65
21	Ethiopia	25.27	44.28	20.22	24.07	27.72
22	Zaire	34.29	51.32	18.68	32.64	7.78
23	Egypt	27.54	22.11	12.50	9.61	35.85

Source:- International Financial Statistics year Book (1996-98) International Monetary Fund

From the above table we can understand that developed countries indirect taxes holds significant place. Because the burden of direct taxes can not be shifted to another, the tax payer's effort to evade is high and this intern needs efficient and strong tax administration. As one can perceive from the table, developed countries like Spain & Sweden highly relied on direct tax not on foreign trade and non tax

revenues like that of developing countries. Within the indirect taxes the share of foreign trade tax remained very minimal in developing countries. On the contrary, for several developing countries, foreign trade taxes played significant role in their revenue basket.

As part of the developing countries, Ethiopia's tax revenue is dominated by indirect taxes. More over, with in this category foreign trade taxes, derived from import duties and taxes contribution is significantly high. In contrast domestic indirect taxes are inferior.

In Ethiopia the revenue from domestic indirect taxes accounts 20 percent of the total revenue against to 41.5, 33.7, 33.9 and 22.9 percent of Kenya, Chad, Ghana and Zimbabwe respectively. In the case of foreign trade taxes, Ethiopia's share stood 24 percent of the total revenue compared to Kenya's 15.2, Chad's 15.3, Ghana's 26.8 and Zimbabwe's 18.8 which may be impossible to implement zero tariffs to the imports of member countries. However, more in view of the current globalization treat it is not plausible to depend on this source of revenue.

The tax system is therefore assumed to depend on stable sources. It is advised that stability to be ensured by avoiding reliance on such vulnerable tax bases, and exploit domestic taxes including broadening bases on income and Consumption taxes, and ensuring compatibility with tax administration capabilities. Thus

revising domestic indirect tax policy aspects and improving its administrations imperative.

The initial failure of the transitional countries including Ethiopia to develop their tax administration when introducing new tax structures resulted in very uneven tax imposition, lower than the predicted revenue, and wide spread tax evasion. Similarly, in some developing countries, like Ethiopia, tax liabilities are often negotiated rather than calculated as set out in the law. This issue can be supported by a number of practical evidences.

For example according to income tax proclamation No.286/2002,Art.86-102 there are both administrative and criminal penalties set for violating the set tax laws. Nevertheless they are hardly applicable in practice through out Addis Ababa city administration as well as the entire country.

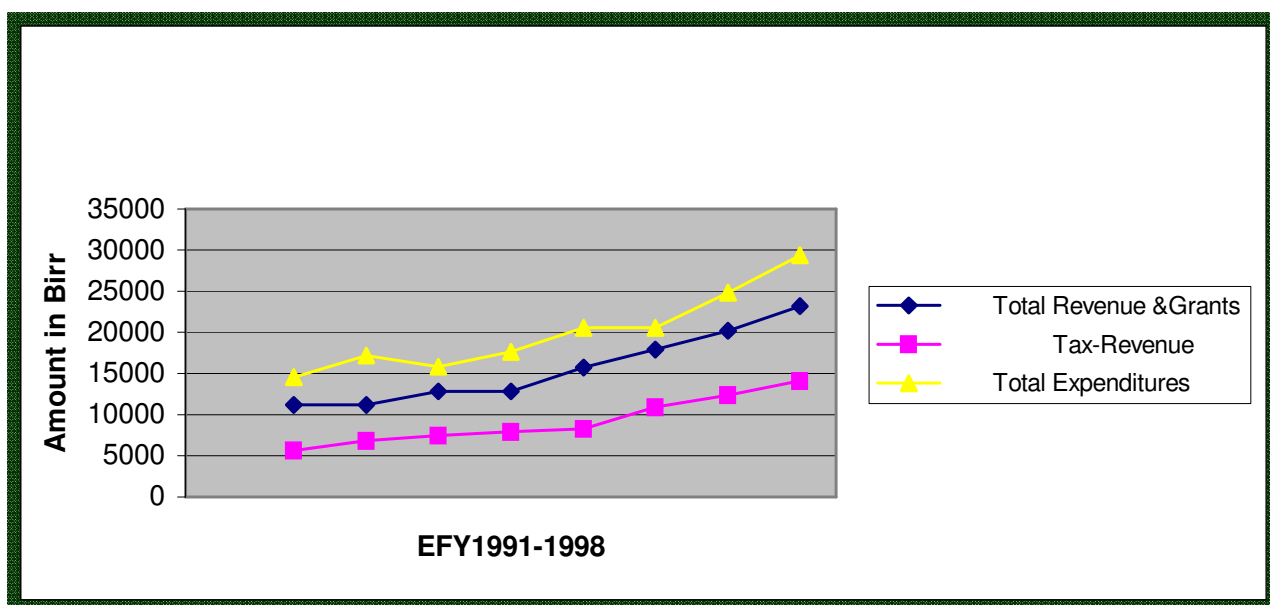
The government has become smooth in this issue after the 1996 E.C. tax levy which was a bit higher than any time and which again resulted public protests especially in main cities and towns of the country. During the 1997 E.C. election, tax was used as a major instrument for different political parties and the ruling party has become smooth after wards especially on direct taxes as can be seen next.

Table3.2 Government Finance

Particulars	In Mn. Birr								
	G.C.	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
	E.F.Y	1991	1992	1993	1994	1995	1996	1997	1998
Total Revenue & Grants		11,215	11,222	12,805	12,833	15,703	17,918	20,147	23,225
Total Revenue (excluding grants)		9,453	9,498	10,177	10,409	11,149	13,917	15,582	19,493
Tax-Revenue		5,592	6,782	7,440	7,926	8,243	10,906	12,398	14,122
Tax-Revenue as % of GDP		9.7	10.5	11.3	12.5	12	13	11.7	11.5
Total Expenditures		14557	17184	15786	17651	20517	20520	24803	29325
Current Expenditures		10127	13742	10379	10550	13549	11977	13235	15234
Capital Expenditures		4430	3442	5003	6130	6313	8271	11343	14042
Special Programs		-	-	404	971	655	272	224	50
Total Expenditures as % of GDP		25.4	26.7	24	27.8	29.8	25.1	25.7	26.4
Percentage share of Tax Revenues to the total revenue of the country		49.86	60.43	58.10	61.76	52.49	60.87	61.54	60.81

Source: National Bank of Ethiopia Annual report 2004-2005 with some arrangement

Graph 3. 1. Government Revenue & Expenditure



As shown in the above table and graph the over all revenue collection of the government of Ethiopia from tax as compared to GDP is not more than 13% which is the list even from many Sub-Saharan Africa countries.

By and large, government's ability to carry out its on going expenditure programs in infrastructure and social sector depends on the level of domestic financial resources, largely expected to flow from its tax system. Nevertheless, Ethiopia's revenue performance over the past decade has been small, when compared to other developing countries. The tax revenue GDP ratio, which had peaked at 13 percent in 1996E.C, however, fell to 11.7 and 11.5 percent in the following two years. It remained low compared to the rationally accepted level of developing countries, which is 20-25 percent.

Compared to other countries in Africa, income tax rates are still high. Various tax studies also advised the elimination of differentials existing between maximum rates across taxpayers. In the tax system, import duties still contribute significant portion of tax revenue nevertheless, the current globalization agenda demands the need to liberalize trade policy. This entails further reduction on duty rates.

However the total expenditure of the country reaches up to a maximum of about 30% during 1995, which shows the economy of the country is highly dependent on non tax revenue sources which accounts up to a maximum of 51% in 1991 EFY and a minimum of 38.5% in 1994 EFY . The total revenue collected during the given periods is much less than the total expenditure incurred on those years. This implies that the effort to increase domestic revenue rather than depending on foreign aid and loan should be increased.

To this view improving the prevailing tax administration specially increasing tax audit efficiency and broadening the tax base are the means. Graph 3.1 also depicts that revenue of the country is by far less than that of each years expenditure incurred for both capital and recurrent government activities. Actually the trend reveals that both the GDP rate of revenue and expenditure growth is almost similar, in which both depicts little decline in stead of increment.

3.3 Major Components of Government Revenue

As can be shown in table 3.3, the government of Ethiopia generates its revenue from different sources, namely tax (direct and indirect), non tax (charges, investment income, property sales etc), and loans and grants. These components of revenue sources are shown in table 3.3 and graph3. as follows.

As shown in the table and the graph below for some years earlier non tax revenue was higher than that of either direct or indirect tax revenues, because during those years especially during 1992 privatization and sale of government enterprises had been mad widely.

For those years under consideration, the share of indirect tax was higher than that of direct tax towards government revenue. From the graph we can understand that both direct and indirect taxes have increased .However, indirect taxes increased at an increasing rate, while direct taxes increase more or less at a constant rate.

The reason for the increased indirect tax revenue (such as TOT, VAT, custom duties etc) is that, these sources of revenue are not levied directly on income of individuals and businesses unlike that of direct taxes and except some it is easy to administer this indirect taxes as compared with direct taxes which are exposed for evasion .

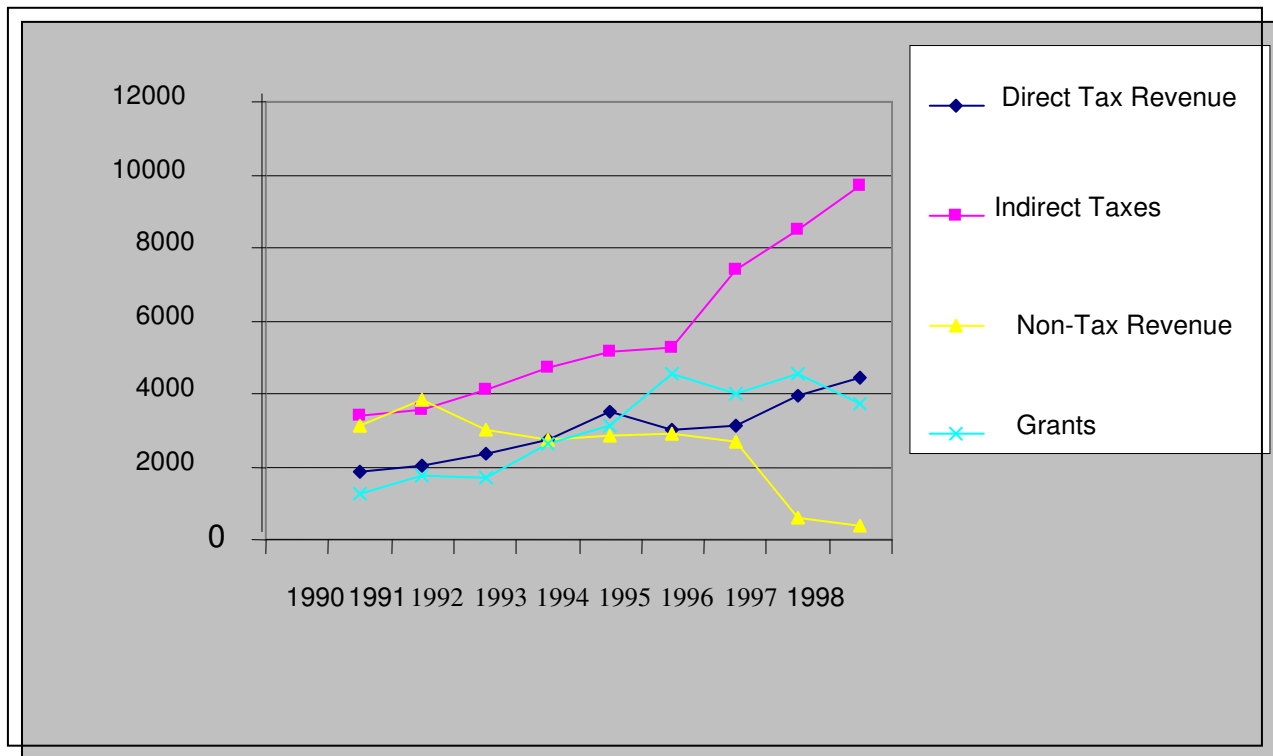
In addition, the burden of these indirect taxes can be shifted towards the final consumer; however the impact is on the businesses and individuals who are given the delegation to collect. Of course, there may be a possibility that, the tax withholding agent or the tax collector may use the money collected from these indirect taxes, so tax intelligence and random review may be applied

Table 3.3 Major components of Government revenue from EFY 1990-1998

Particulars	EFY	1990	1991	1992	1993	1994	1995	1996	1997	1998
Total Revenue and Grants		9686.4	11215.2	11222.1	12805	14628	15,703	17,188	24,096	26,615
Total Revenue ¹		8443.1	9453.2	9498.4	10177	11506	11,149	13,186	19,531	22,883
1 Tax Revenue		5268.7	5591.6	6482.8	7440	8646	8,243	10,520	12,398	14,159
1.1.Direct Tax Revenue		1869.4	2008.8	2367.3	2735	3512	3,010	3,132	3,930	4,461
1.1.1Income Taxes		1523	1680.4	1952.6	2143	2636	2,878	2,832	3,569	3,819
- Personal		433.6	505.2	593.9	686	794	833	948	1,132	1,414
- Business		1089.4	1175.2	1358.7	1457	1842	1,639	1,303	1,714	1,741
1.2 Rural Land Use Fee		97.8	108.4	111.5	117	127	406	581	723	665
1.3 Urban Land Use Fee		115.6	66.9	86.8	123	201	88	114	140	124
1.4 Others		133	153.1	216.4	352	548	44	186	221	517
2. Indirect Taxes		3399.3	3582.8	4115.5	4705	5134	5,233	7,388	8467	9698
2.1 Domestic Taxes		1180.8	1204.3	1439.7	1381	1830	1,668	2,112	2721	3111
2.2 Foreign Trade Taxes		2218.5	2378.5	2675.8	3324	3304	3,565	5,276	5746	6587
- Import		2037.2	2223.2	2527.6	3231	3252	3,564	5,276	5746	6587
- Export		181.3	155.3	148.2	93	52	1	0	3184	5371
3. Non-Tax Revenue		3144.4	3861.6	3015.6	2738	2860	2,906	2,666	7134	8724
3.1 Charges and Fees		130.7	176.6	200	179	298	252	321	1106	3136
3.2 Gov. Invt. Income		1400.2	1423	1183.5	1353	1249	1,102	1,250	193	310
3.3 Reimb. and Property Sales		92.2	91.8	474.6	203	217	204	185	856	433
3.4 Sales of Goods & Services		164.1	282.4	356.6	340	427	330	376	414	1113
3.5 Others		1357.2	1887.8	800.9	663	669	1,018	534	4565	3732
4. Grants		1273.3	1762.1	1724.1	2628	3122	4,554	4,002	4565	3732

Source: Ministry of Finance and Economic Development

Graph 3.2 the trend of major government revenues



Source: Ministry of Finance and Economic Development

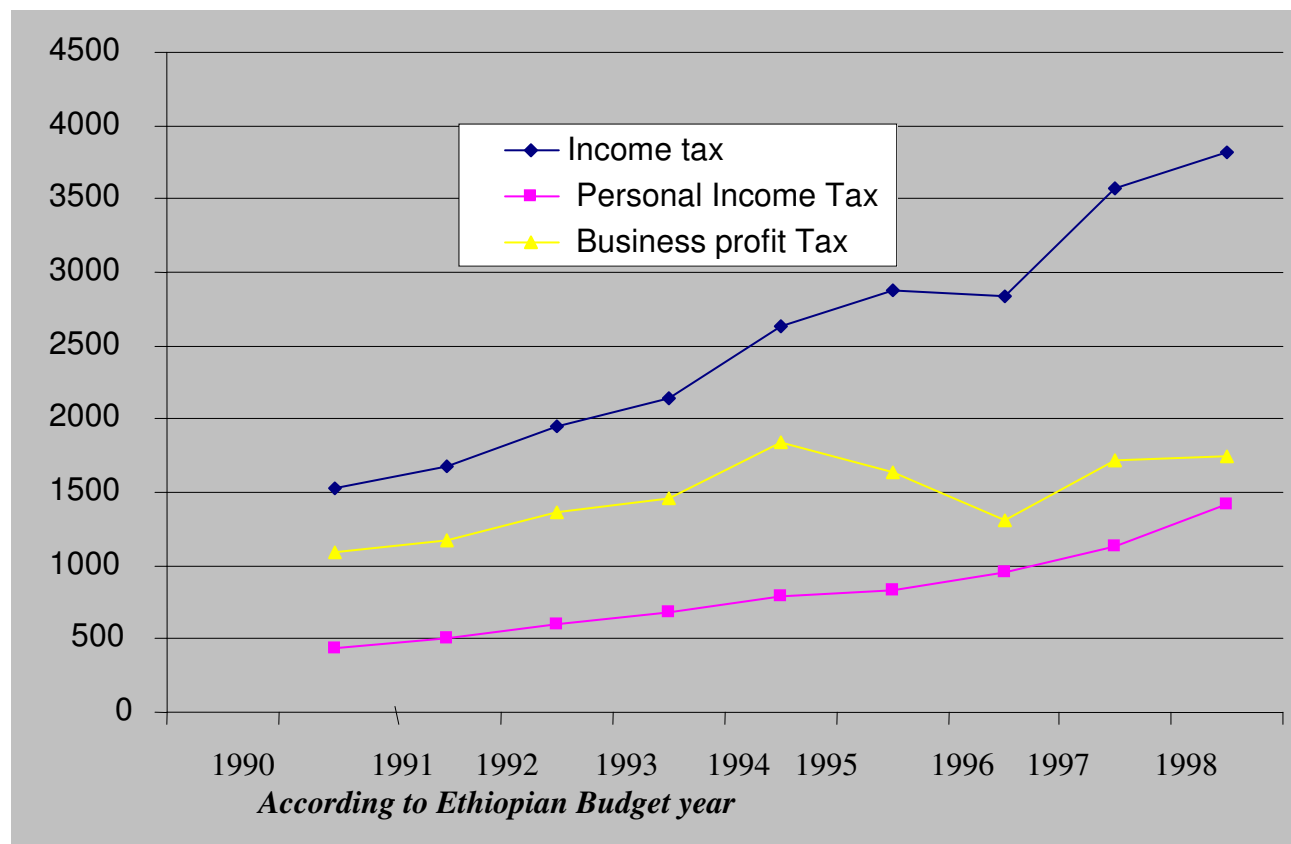
As shown in the graph below income tax is one of the main components of direct tax including with others shown in table 3.3 above. Even if the share of business profit tax is high as compared to personal income tax, it doesn't increase at a constant rate while personal income tax increases at a constant rate. The reason is that, personal income tax which is mainly collected from employment with out much effort.

This source of tax doesn't need critical assessment other than checking whether the amount withhold by the employer is forwarded to the respective tax authority or not. However, business profit tax is collected from the profit of traders needs much effort to levy and collect due to the high risk of understatement and evasion.

Most tax payers use all mechanisms that could understate their tax liability. This implies tax auditors have greater responsibility to audit and investigate any sort of understatement made by the tax payer and reassess the appropriate tax liability.

Graph 3.3 Main components of Income taxes

In Million Br.



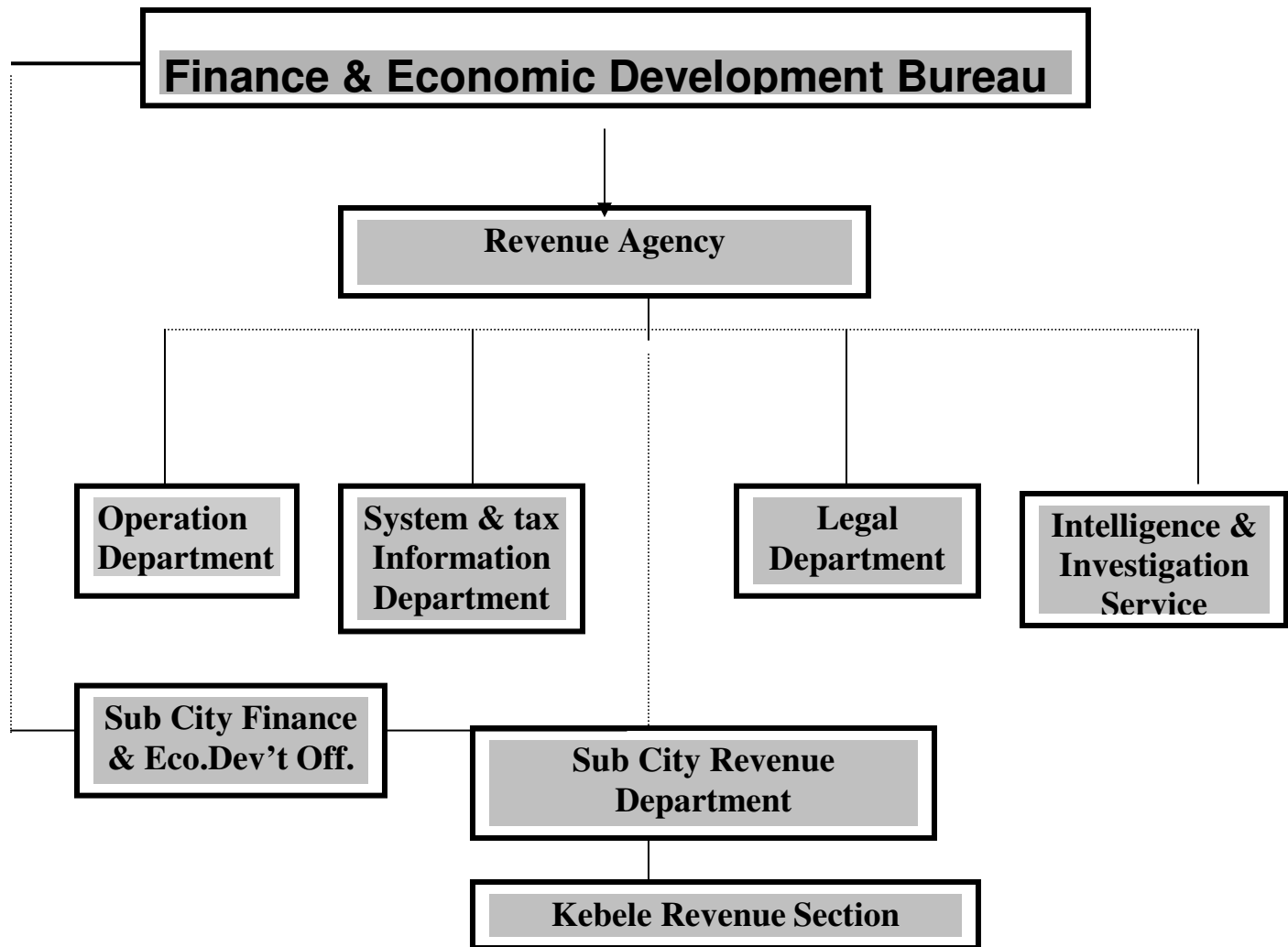
Source: Ministry of Finance and Economic Development

3.3. Tax administration in Addis Ababa City Administration

Addis Ababa is the capital city of Ethiopia as well as Africa. It is also the seat of many international organizations, embassies and agencies. Addis Ababa is a self-governing chartered city established by Article 49 of the constitution with around 3.4 million people.

Addis Ababa City Revenue Agency is established by Charter proclamation No.311/95E.C for the purpose of administering tax with in the city. It has ten sub city revenue departments as well as in offices in ninety nine ‘kebeles’ responsible for levying and collecting taxes from it’s territory and revenue sources given to the city by the tax proclamation.

The structure of Addis Ababa City revenue agency is shown in the following chart.



Source: Addis Ababa City Revenue Agency

Tax administration reforms are designed to enhance the accuracy and fairness of assessment, increase the efficiency of collection, reorganize the tax and customs administrations along functional lines, and improve taxpayer registration procedures as well as collection enforcement and audit. In addition computerization is also required for more effective management of taxpayer's data bases, while pay incentive programs and greater autonomy for the tax authority, supported by development of specialized skills among tax officials are intended to promote honesty and efficiency in tax administration.

There is no best tax policy in the world without efficient and effective implementation and administration. Hence tax policy design must take into consideration the administrative issue as the corner stone. The resources used in administering and complying with tax laws are real economic costs, in terms of the ability of the country to provide goods and services. To this view there are three main essential issues to effective tax administration:

- ✚ the political will to administer the tax system effectively,
- ✚ a clear strategy for achieving these goals,
- ✚ adequate resources to implement.

3.4 Revenue performance of Addis Ababa City

As can be shown in the table 3.4, the revenue performance has increased from year to year. However, in almost all the years under consideration, the contribution of non tax revenue is higher than that of tax revenue in all the years. The main component of non tax revenue that has higher contribution to the City's revenue is sale of urban land in lease.

For example, according to 1998 EFY accounts report, it accounted Br.532, 282,675.45 which is almost 20% of the total revenue. In addition when we see the direct taxes for almost all years the tax from employment income is higher than tax from business profit tax. The reason is that, employment income tax doesn't need much effort since it is deducted from payrolls by the employer.

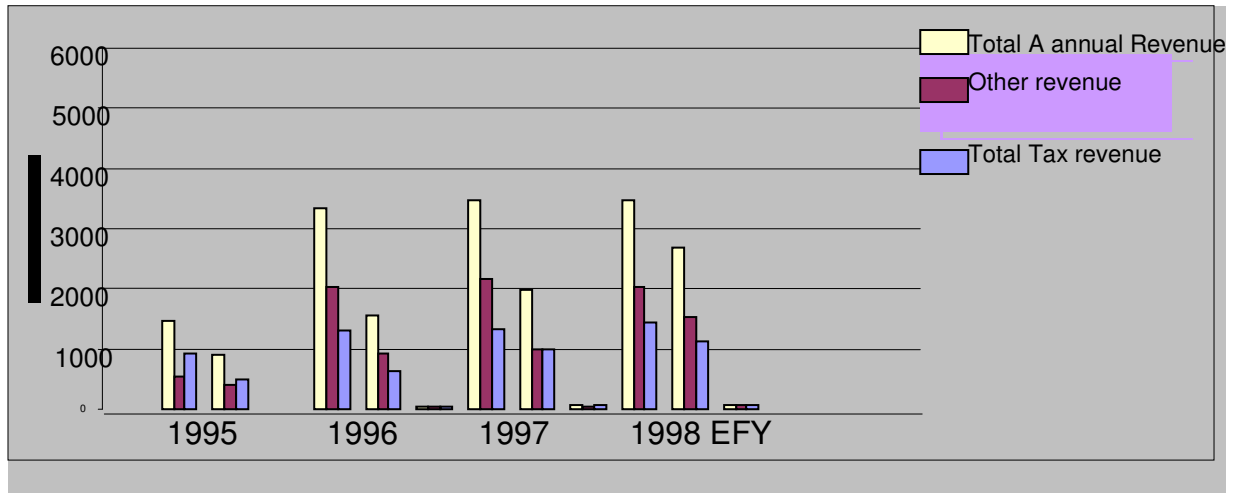
Where as, business profit tax needs much effort from the tax authority due to the practice of tax evasion by tax payers. In principle in a city where much of the business activities are carried on, the tax that is generated from business profit tax should not be less than that of employment income tax. This shows that the tax administration capacity of the city administration is not as strong as it would be. Had it been strong, it could collect more tax from the business. The main reason is that the tax administration capacity of the city is not much strengthened, specially the audit aspect.

Table 3.4. Revenue Performance Summary of Addis Ababa City Administration for Four years

Particulars	EFY1995			EFY1996			EFY1997			EFY1998		
	Budg.	Act.	Percent	Budg.	Act.	Percent	Budg.	Act.	Percent	Budg.	Act.	Percent
Direct tax revenue	748.06	373.48	49.9	840.46	629.74	74.93	942.43	731.72	77.64	788.38	875.62	111.1
Indirect tax revenue	168.69	122.2	72.4	460.46	596.68	129.6	385.87	253.51	65.70	657.45	154.1	23.44
Total Tax revenue	916.74	495.68	54.1	1300.92	1226.42	94.27	1328.3	985.23	74.17	1445.83	1029.71	71.22
Other revenue	547.29	415.53	75.9	2034.62	413.17	20.31	2155.68	991.21	45.98	2030.61	1647.88	81.15
Total Annual Revenue	1464.03	911.21	62.2	3335.54	1639.59	49.16	3483.98	1976.44	56.73	3476.44	2677.59	77.02

Source: BoFED of Addis Ababa City Administration Budget Proclamation and Accounts Report (However own computation)

Graph 3.4 Graphical presentation of Revenue Performance in A.A



Source: BoFED of Addis Ababa City Administration Budget Proclamation and Accounts Report (However own computation)

The trend of revenue performance can also be shown in graph 3.4 above. As compared to other regions of the country, Addis Ababa City doesn't get budget from the Federal government which shows it is a self financing city due to being the main trade center of the country. However, even the City Revenue Agency doesn't administer all sources of tax due to wide spread evasion and lack of awareness especially taxes from business profit and rental income. The total tax revenue share of Addis Ababa City administration to that of the country's total tax revenue was 6.01%, 11.66%, 7.19% and 7.27% for the years starting from EFY1995 to 1998 respectively which is less as being the main trading center of the country.

3.4. Declaration of Income and Assessment of Taxes

As stated earlier there are two types of assessment in Ethiopian context. These are Administrative assessment and Self assessment.

Taxpayers shall submit the tax declaration to the Tax Authority at the time of submitting the balance sheet, and the profit and loss statements for that tax year within the time prescribed below:

- a) Category “A” taxpayers within four months from the end of the taxpayers’ tax year;
- b) Category “B” taxpayers within two months from the end of the taxpayers tax year.

A standard assessment method is used to determine the income tax liability of category “C” taxpayers. The taxpayer should pay the tax determined in accordance with standard assessment from the 7th day of July to the 6th day of August every year, unless, the taxpayer requested and is allowed to make installment payments.

If no records and books of accounts are maintained by the tax payer, or if, for any reason, the records and books of accounts are unacceptable to the tax authority, if the taxpayer fails to declare his or its income within the time prescribed by the proclamation, the Tax Authority may assess the tax by estimation. Unless and otherwise provided, the period for tax assessment is the one-year period from 1st

of 'Hamle' to 30th of 'Sene'. A body shall not change its accounting year unless it obtains prior approval, in writing, from the Tax Authority and compiles with any condition that may be attached to the approval.

After the taxpayer has submitted a declaration of income within the time and manner prescribed in the proclamation, the Tax Authority has five years to amend the assessment. The five years assessment period runs from the due date of the declaration.

In case where the taxpayer has not declared his income or has submitted a fraudulent declaration, no time limit provided in any other law shall block the assessment of the tax by the Tax Authority. However this is too long and difficult for the tax payer to provide appropriate documents after five years if asked by the auditor.

According to the response of the respondents for the question presented with regard to administrative assessment visa vise self assessment is summarized in the following table.

Table 3.5 Types of Assessment

Which type of assessment contribute (generate) higher revenue?			
Responses	No. of Respondents	Percent	
Administrative Assessment	14	77.78	
Self Assessment	4	22.22	
Total	18	100	

From the above table we can understand that the main type of assessment that yields higher revenue to the government is administrative assessment as responded by 14(77.78%) respondents. Of course it is reasonable because the majority of tax payers don't maintain book of accounts. This fact depicts that majority of the tax payers don't maintain accounting records which intern leads administrative assessment.

It is clear that administrative assessment is basically based on estimation which may either complain on behalf of the tax payer or a revenue decline on behalf of the government. It is unquestionable that tax assessment based on estimation without evidences creates inconvenience on either the tax payer or the government

3.5. Record Keeping Requirement

All persons who are engaged in a business or trade or who own buildings held all or in part for rental, except for Category “C” taxpayers shall keep books and records. Those businesses that are required to keep books of accounts and records are also required to keep the following information:

- ❖ Record of the business assets and liabilities, including a register of fixed assets showing the date of acquisition, the cost of acquisition, and the current book value of each asset;
- ❖ Record of all daily income and expenses related to the business activity and the matter to which they relate;
- ❖ Record of all purchases and sales of goods and services to the business activity showing:
 - The particular goods and services sold;
 - The name of the buyers and sellers or providers in such a manner that they can be identified by the Tax
- ❖ Authorities pre-numbered invoices containing the vendor’s tax identification number;

- ❖ Record of trading stock on hand at the end of the accounting period, including the type, quantity and cost of that stock as well as the method of valuation of that stock;
- ❖ Any other document relevant for the determination of the tax liability;
- ❖ If a taxpayer has certain books or records in a foreign language, the Tax Authority may require that they be translated into one of the official languages of Ethiopia at the taxpayer's expense.

According to the 286/2002 tax proclamation all businesses classified under category 'A' & 'B' should maintain their own accounting records. However, this is what the law requires but not the practice. In practice most tax payers of tax payers that are eligible to maintain accounting records don't have proper accounting records. The main reason for this is that tax payers don't have the proper awareness about the advantage of maintaining book of accounts and the law which enforces that tax payer to maintain proper accounting records is not properly implemented by the responsible authority.

From the trend in most cases, they have understood that the tax that will be paid by estimation is less and it gives them an opportunity to negotiate with the assessor as per the interview obtained from Addis Ababa City Revenue Agency officials. In addition, they don't want to hire accountants and tax return preparers which will lead them to extra expense.

For example according to the information found from Addis Ababa City revenue agency the number of tax payers who had maintain book of account were 31,534 out of a total of 169,233 which is around 18.6%.This reveals that in one or another reason, almost all of the tax payers don't want to maintain book of accounts.

3.6. Prevailing extent of assessment & Audit in Addis Ababa City Revenue Agency

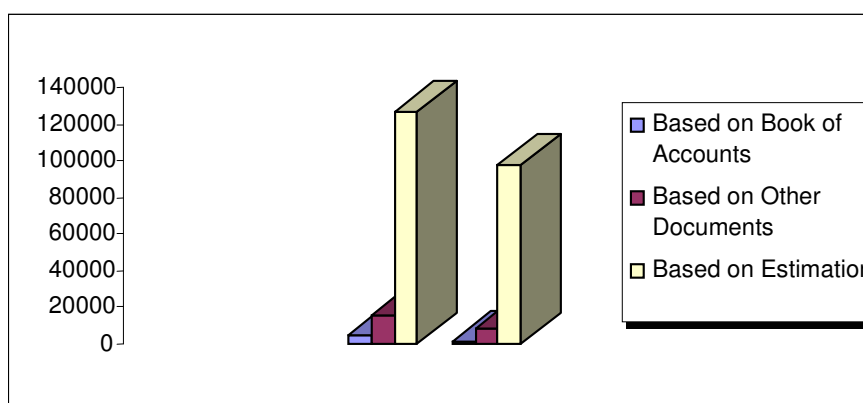
There are no sufficient and available statistics about the extent of assessment under the prevailing tax audit net. From a personal interview and questionnaire with tax officials of Addis Ababa City Administration, sub city tax auditors as well as FIRA'S Authorities those are responsible and top taxation body; it has been revealed that the tax audit net is very insignificant as compared to the whole tax net. For example the tax assessment and audit performance of Addis Ababa City Revenue Agency performance is shown as follows:

Table 3.6. Tax Assessment and audit performance of Addis Ababa City Revenue Agency for 1999EFY.

Particulars	No. Of Files to be Audited/Assessed	No. of Files Audited /Assessed	Performance in Percent	Revenue Obtained including Penalty in million Br	Revenue Collected including penalty in million Br.
Based on Book of Accounts	4771	1355	28.4	123.04	
Based on Other documents	15789	7577	48.0	29.21	
Based on Estimation	127532	98452	77.2	208.6	
Total	148092	107384	72.5	360.85	180.9

Source: Addis Ababa City Revenue Agency 1999 Annual Report (summarized)

Graph 3.5 Graphical presentation of audit and assessment performance for A.A City



As shown in table 3.6, the total assessment and audit performance was achieved 72.5% from the planned. However when we see the audit aspect separately which is applied for those who maintain accounting records, it is too low (28.4%), which means out of the total 107,384 files only 1355 files are audited. The main reason is that most of the tax payers don't maintain accounting records. If this is the practice in Addis Ababa where majority of the tax payers are assumed educated to a certain level at least to understand the advantages of maintaining accounting records as well as where there are many accountants to get consultancy and advice as compared to other regions of Ethiopia, it would be worsen in other regions where there are no accountants to consult and where the taxpayers are illiterate.

Further more, as shown in the above table from 1355(1.26%) tax payers the amount of revenue obtained is Br.123million which is around one third of the total revenue by the City revenue agency for the year from income.

The criteria for compulsory tax audit have to be based on gross turnover or gross revenue, not on capital. Because profitability in terms of absolute or residual income (RI) which is the very tax base, is obviously indicated in a better way by the gross revenue inflow than in terms of relative income such as return on investment (ROI) based on capital. It can be usually assumed that the higher the

gross earning, the higher the taxable income. But higher capital does not necessarily mean yielding higher income.

The questionnaire about the selection of files to be audited reveals this fact. Most respondents replied that audit cases are selected by auditors based on the gross sales or revenue and the risk of exposure to evasion after reviewing the financial reports prepared by the tax payers.

3.7. Coverage and types of tax audit in Ethiopian context

Since audit presupposes accounting, tax audit may cover the heads of income for which any method of accounting must be followed for recording purpose. Any type of tax whether direct or indirect tax is subject audit to verify the accuracy of tax liability.

However in practice what tax auditors of the city mainly apply audit for business profit and VAT tax. Because the audit conducted in all sub cities is desk audit which broadly is based on documents of the tax payer. According to the interview, the main reason of the sole use of desk audit is that field audit is assumed as it increases the risk of corruption by tax auditors.

As mentioned above under Ethiopian tax proclamation No. 286/2002 category A and B tax payers shall maintain their own book of accounting records and at the

end of the year shall submit to the tax authority a balance sheet and a profit and loss statement supported by appropriate vouchers and document. These two category tax payers are obliged to maintain their book of accounting records.

Where as category C tax payers don't have the obligation to maintain book of accounts and in this case the tax shall be assessed by standard assessment (presumption), however, if they maintain their book of accounts the tax auditor shall assess based on the book. And audit is mandatory for category A & B tax payers. So tax audit has to be imposed on business or professional income with an expanded base so as to ensure proper maintenance of account and independent scrutiny thereof by auditors. As responded by the respondents almost all of them said that the type of audit that is applied is determined by the situation. However, most of the time full audit is applied .In rare cases and in some conditions and for certain types of taxes like VAT and TOT, either single issue or limited scope audit may be applied

3.8. Corruption vs. Tax Audit in Ethiopia

As defined in the literature part, corruption is a combination of increased monopoly power and integrity with no or less accountability.

In Ethiopia the work of the tax inspector is neither audited by other individuals nor performed in group. As per the tax auditors response one file is usually

audited by one individual auditor. It implies that, the tax audit is exposed for the risk of corruption. So, if the public tax auditor and the tax payers communicate to make corruption the door is open. In the prevailing tax audit practice of Addis Ababa City revenue authority, tax audit doesn't contribute much to minimize corruption rather it broadens the opportunity of corruption, because tax audit is performed usually by a single tax auditor.

Further more, the wages and salaries paid for the tax officials and auditors is low as compared to other jobs private and NGO's. Of course with respect to benefit for employees employed in any position of the Finance Bureau and under its offices the required experience is less than other civil servants. For example in A.A City Administration and in any one of its offices an individual who has BA degree and nine years of professional experience can be appointed as team leader with a monthly salary of Br.2762.00, where as in other government civil service offices an individual to apply for the same position, he should have BA degree and 14 years of experience.

According to Ethiopian income tax proclamation No.286/2002 Art.99 offences by the tax authority employees asking for or receiving any benefit for which the office is not legally entitled to receive or enters into an agreement to do or to abstain from doing permit, conceal or conspire(work against) at any act or thing where by the tax revenue is or may be defrauded or which is contrary to the tax provisions

of the proclamation or to the proper execution of the officer's duty and who exceeds the authority conferred up on the tax authority or misuses such authority commits an offence and is liable, on conviction to a fine of not more than Br.50,000 and to imprisonment for a term of not less than 10(ten) years and not more than 20 (twenty)years .

Even if the law says this as per the responses of tax officials of Addis Ababa City administration, no one is found guilty in relation to this article. However it doesn't mean that there is no corruption rather the way it is made is beyond the scope of the mechanism to investigate, because it is deliberately done by the agreement of both the tax payer and the tax auditor. There are many indicators of corruption in tax related issues. As one of the Addis Ababa City Administration Sub City tax auditor expressed, even those students sent for practical attachment were red-handed when they receive certain amount of money and up to Br.100,000 was found on their account .If this is done by a practitioner ,it is simple to judge what will be done by the permanent employees those who have the interest to abuse their power.

3.9. Efficiency and Effectiveness of Tax Audit

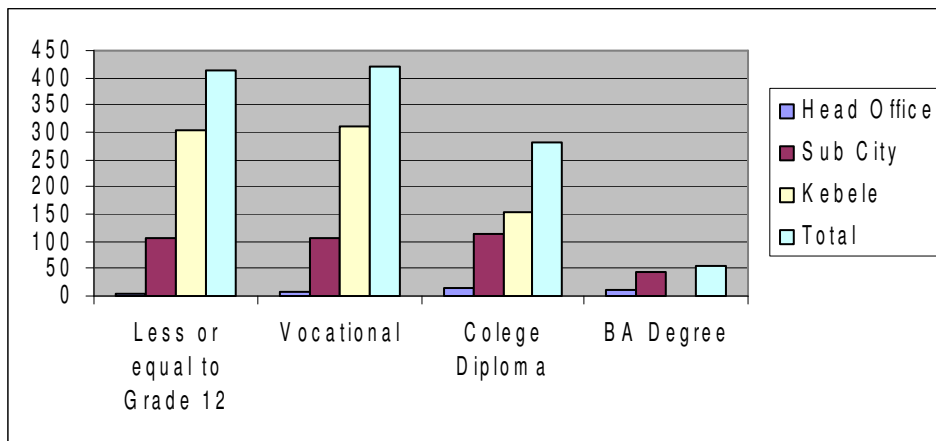
Before we discuss about the efficiency and effectiveness of tax audit and assessment it is better to see first the profile and educational background of employees.

Table 3.7 Employees of Addis Ababa City Revenue Agency including Sub cities & Kebeles

Office	Educational Qualification							Total positions occupied
	No. of Positions	Less equal or to Grade 12	Vocational	College Diploma	BA Degree	LLB Degree	MA Degree	
Head Office	42	4	7	13	11	2	0	37
Sub City	515	105	105	114	43	2	3	372
Kebele	883	304	310	153	0	0	0	767
Total	1440	413	422	280	54	4	3	1176
Percent		35.12	35.88	23.81	4.59	0.34	0.26	81.67

Source: Addis Ababa City Revenue Agency

Graph 3.6 Employees of Addis Ababa City Revenue Agency including Sub cities & Kebeles



Source: Addis Ababa City Revenue Agency

The above table shows the qualification of employees in the revenue agency of Addis Ababa City and around 70% of the employees are below diploma level. Where as the total number of BA degree holders specially found in head office

and sub cities is 54(4.59%). Tax audit based on financial statements is made at sub city level. That is why assessment performance made based on book of accounts and based on other documents is less as compared to assessment by estimation. Assessment by estimation (presumptive tax) for category 'C' tax payers is made at kebele level.

The efficiency and effectiveness of a revenue body's audit activities depends critically on the nature and scope of powers in the underlying legal framework in place, including the provision of adequate powers for obtaining information and an appropriate regime of sanctions to discourage and penalize non-compliance. In addition as discussed in the literature part, efficiency of tax audit considers the conduct of effective audit with less time and cost.

In addition for the effective and efficient tax audit not only the skill and qualification of tax auditor's but also adequate number of tax auditors have greater impact. As per the interview presented for one of the Sub Cities (Addis Ketema where there are large number of tax payers), the number of tax auditors are two BA degrees, and two Diplomas for the assessment and audit section, as well as two BA degrees& two Diplomas for VAT section. This is the same for all sub cities. In addition, as per the results of the interview presented there is no any training for tax auditors.

The other issue which has an impact on the efficiency of tax audit is that tax laws are not stable and consistent; especially tax rates have been revised three times during the past five years. (See annex 2)

3.10 Measure of efficiency and effectiveness

In Ethiopia the effectiveness and efficiency of tax audit is measured by the volume (No.) of files audited from the planned. For the question presented the effectiveness and efficiency measures, the response given are summarized in table3.6 below.

Table 3.8 Question: How do you measure the effectiveness of tax audit operation?

Possible Measures	No. of Respondents	Percent
Yield& Productivity	3	15.79
Volume	10	52.63
Quality Measures	2	10.53
A combination of two or more	4	21.05
Total	19	100.00

Even if the effectiveness of a tax audit is measured by a combination of the above measures presented in the possible measure column, 52.63% respondents have responded that they used volume as a measure of their audit activity. And if one concentrates on effectiveness which is measured by quantity, it is difficult to achieve efficiency, since efficiency concentrates on the inputs utilized to achieve the desired outcome.

In addition as seen in table 3.6, most of the employees engaged in the assessment and audit task are not well trained and qualified. This also has greater impact on the efficiency and effectiveness of audit and assessment. The other issue which affects the efficiency and effectiveness of tax audit is absence of adequate information, due to the broad application of desk audit.

In principle, tax audit is one of the most sensitive contacts between the taxpayer and a revenue body, the presence of an auditor in a taxpayer's private dwelling or business premises, coupled with the exploration of private and business issues and the gathering of information from taxpayers' books and records, or just the disruption of day-to-day workflow, represents a burden on the taxpayer and may be seen by some as an unwarranted intrusion into their affairs. However in practice, since desk audit is usually applied this is not that much a problem. Notwithstanding this, tax audits remain the only effective method for ascertaining additional facts or verifying provided information. Legal frameworks are essential

to provide integrity in the way tax administrations carry out audits and to ensure that taxpayers' rights are properly protected.

In general, the tax revenue performance in Ethiopia as compared to GDP ratio as shown earlier, which had peaked at 13 percent in 1996E.C, however, fell to 11.7 and 11.5 percent in the following two years. It remained low compared to the rationally accepted level of developing countries, which is 20-25 percent. Furthermore the tax audit practice, which has an impact on the performance of revenue generated from tax, is weak as seen in Addis Ababa city revenue agency. The less performance of the tax revenue collection makes the country to be dependent on non tax revenues.

CHAPTER FOUR

CONCLUSION AND RECOMMENDATION

All countries need to collect taxes for several reasons, such as to finance developmental activities, to meet their day-to-day expenses related to maintenance of a free and fair society, to control the economy through fiscal measures, and to a certain extent, to change the economic behavior of people. The authority of national governments to collect monies from taxpayers must recognize a balance between the nations' authority to tax and taxpayers' rights. Thus, the real challenge for nations is to ensure that taxpayers are treated with fairness, justice, and equity, while national governments emphasize their authority as taxing authorities.

4.1 CONCLUSION

According to the analyses and findings obtained from the study, in history the highest tax to GDP ratio in Ethiopia is 13% which is registered in 1996 EFY. Where as, the minimum expenditure to GDP ratio in Ethiopia is about twice that

of the tax to GDP ratio (24%). From this we can conclude that there is huge gap between the revenue collected and the expenditure incurred for those years.

In addition, most of the country's revenue is not tax rather non tax revenues like grants and other non tax sources which accounts from a minimum of 13% in EFY1990 to a maximum of 29% in EFY1995 and from a minimum of 15% in 1996 to a maximum of 34% in 1991 EFY respectively. These sources are not stable sources of government revenue to finance government's activity.

It can also be generalized that, the main sources of tax for the government are indirect taxes, such as VAT, TOT, Excise tax and other import export duties levied on foreign trade. This is because, it is easy to levy and collect taxes from indirect taxes as compared to direct taxes which are applied on income of businesses and individuals. However, when we compare the composition of the two types of taxes (direct and indirect) in case of Addis Ababa City, direct taxes are the main sources. The reason is many of the indirect taxes are collected by the federal government such as VAT, excise taxes and other import export custom duties. Those business men who initially registered for VAT pays the whole tax they have collected for the federal government even if they are performing the business in the City.

A sound tax system should identify surpluses in the economy and should tax it in such a fashion as to cause minimal damage to productive activity. Tax collection

should act as a catalyst for economic growth. Ideally a tax system should be neutral with respect to its effect on economic behavior. In the real world, however, it is impossible to achieve neutrality.

The tax authorities of Ethiopia face many challenges in the massive task of tax collection. The main challenges can be summarized as follows:

- Lack of a taxpaying culture
- Weak accountability
- Lack of transparency
- Weak audit performance
- Unstable tax amendments

Nevertheless the problem of tax evasion bothers revenue agencies established at different levels of the city as well as the country. In the real world, those who wish to reduce their tax liability have more choices than just tax evasion. Smarter and more sophisticated taxpayers, who find the cost/risk of evasion greater than the benefit, practice risk free legal ways of non-payment of taxes rather than obvious tax evasion, which is popularly known as tax avoidance.

For the government, the results of tax evasion and tax avoidance are the same; for the taxpayer, however, tax avoidance is preferable because there are less or no chances of getting caught and prosecuted.

It is evident from the discussion in the previous sections that the issues surrounding corrupt tax practices are complex, and not amenable to quick or easy solutions. Not surprisingly, one-off measures such as the granting of tax amnesties, or the withdrawal from circulation of large denomination currency notes, have had predictably disappointing results in countries around the world. Many countries have also had committees of enquiry, which have dealt with tax reform issues, including corrupt tax practices. The outcome of these efforts has also, at best, been mixed.

It has become increasingly understood that without the imposition of fundamental complementary changes, tax reforms in and of themselves do not have a long lasting impact.

With regard to the employees assigned in different tax positions most of them don't have the necessary skills which enables them to perform their duties and responsibilities. Besides, adequate short term and refreshment training is not given for those who are working on tax audit and assessment.

The other important issue which should be seen seriously is that, the prevailing tax audit practice as seen in Addis Ababa City Administration is carried out mainly based on internal documents produced by tax payers. It is clear that, documents internally produced can not be a reliable source of information. Further more, the type of tax audit performed by tax auditors is only desk audit.

So far there is no field audit which may assist to the affective and efficient audit operation.

4.2 Recommendations

In light of the tax administration, in the context of Ethiopian tax audit practice with a special reference of Addis Ababa City Revenue Agency, based on the findings obtained the following recommendations are forwarded:

Continuous education should be provided to the tax payers; by the respective revenue agencies specially to create awareness about their rights and obligations so as to build and develop a citizen who has better value in tax.

For effective and efficient revenue collection, governments need to curb not only the tax evasion but also the tax avoidance by applying effective and efficient tax audit based on reliable evidences and documents. The tax collection system should be designed in such a way that not only the tax evasion but also the tax avoidance becomes difficult for the taxpayer.

Increased accountability and an open and honest relationship with taxpayers are crucial for maintaining public trust and confidence in the performance of tax administration. Taxpayers must be able to expect a high degree of certainty in their dealings with revenue agencies. This can only be achieved when tax laws, regulations, procedures, and administrative guidelines are made public, easily

accessible, and applied in a consistent manner by avoiding unstable tax laws which creates confusion not only for tax payers but also for tax auditors.

Reforms of tax legislation and collection procedures, including measures to improve accountability, and transparency in the taxpayer-tax officer relations, should take place concurrently to reduce opportunities for corruption and the demand for corrupt services.

The main ways in which the opportunities for corruption may be reduced include:

- ❖ Clarifying, streamlining laws and procedures in order to reduce official discretion.
- ❖ Making tax rules and regulations more transparent- In the case of taxes simple measures such as posting the various charges prominently, disallowing the use of any receipts other than machine-printed receipts, and using IT to disseminate forms and information could help minimize information asymmetry and reduce the discretionary power of low-level bureaucrats. Of course there is a good start in Addis Ababa city revenue agency, which is trying to connect all Sub cities and 'kebeles' with network with head office and it should be strengthened and other regions should also follow it.
- ❖ A tax guide not only written in the local language, but in simple and plain language that a lay man can easily understand, could also help taxpayers to negotiate daily routines. The guide should include a code of

conduct for tax officials including auditors and politicians who are assigned with revenue generating responsibilities.

- ❖ Devising a scheme to give due recognition to taxpayers, both individual and corporate, which maintain a good taxpaying record over a considerable period of time.

Finally it is clear that most taxpayers of any country do not want to pay taxes unless compelled by a situation where they are left with no option other than to pay the taxes. Therefore, for better tax compliance, a system should be designed that automatically extracts taxes rather than leaves the payment of taxes to the voluntary choice and morality of taxpayers. To this view tax audit is one of the most powerful revenue administration tool that enforces tax payers to pay their tax liability without evasion. There fore the tax audit function should be strengthened to minimize both deliberate and innocence tax evasion made by many tax payers with appropriate expertise and the necessary resources should be allocated for this tax administration function.

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26. <http://www.mofaed.gov.et>
27. <http://www.asosai.org>
28. <http://www.oecd.org>
29. <http://www.mor.gov.et>
30. <http://www.nbe.gov.et>
31. <http://www.fira.gov.et>

Annex I

Addis Ababa University
Faculty of Business & Economics
Graduate Program (MSC) in Accounting and Finance

Questionnaires for tax auditors

Survey questionnaire to study “Tax Audit Practice & its significance in increasing Revenue, the case of Addis Ababa City Administration

The purpose of the study is to analyse the prevailing tax audit practice and its significance in revenue generation taking Addis Ababa as a case.

Responding this questionnaire may not take much time .Any information provided would only be used for academic purpose. As a result it would be kept confidential & utmost secrecy would be maintained. I thank you in advance for your cooperation.

Mesfin Gebeyehu

Position of the respondent_____

Qualification_____

Experience in tax related job_____

Sex _____

Age_____

Instruction: Please make a tick (✓) mark you thought appropriate and your opinion for the open ended questions.

Note: You can also give your opinion in Amharic language.

1. Is there any tax audit manual?

☐ Yes ☐ No

2. If you have the manual how do you evaluate it?

☐ It is clear and workable ☐ It lacks some clarity
☐ It is completely unclear

3. How much do you know the rule and regulation related to tax?

☐ Yes ☐ almost all
☐ Partially ☐ I don't know

4. If the answer for No. 3 is I don't know, how do you carryout your audit funding?

☐ Referring rules and regulations
☐ Working with someone who has better knowledge
☐ As per the knowledge gained through education and training

5. What are the types of assessment practiced in Ethiopia?

☐ *Administrative assessment* ☐ *Self assessment* ☐ *both*

6. Which type of assessment contribute (generate) higher revenue?

☐ *Administrative assessment* ☐ *self assessment*

7. Which type of assessment is exposed to the risk of misappropriation?
Why?

8. Do the auditors and investigation staff have appropriate powers of access to information held by the tax payers and other parties?

☐ *Yes* ☐ *No*

9. If for the above, the answer is 'no', how can an auditor perform its activities?

10. Do the respective government officials give/pay close attention for the tax audit for example by assigning appropriate & skilled persons allocating sufficient resources?

Yes *No*

☐ ☐

11. What are the types of audit most usually applied?

☐ *Full audit* ☐ *limited scope audit* ☐ *single issue audit*

☐ *Any of the three as appropriate depends on the risk identified*

12. How do you measure the effectiveness of any audit technique?

☐ *Yield & productivity measures*

☐ *Volume measures*

☐

Quality measures

☐ A combination of two or more of the measured as appropriate

13. *Is there a mechanism to evaluate the audit activities?*

☐ Yes ☐ No

14. *If the answer is "yes" who and how is it going to be evaluated?*

15. *How are audit cases selected?* _____

16. *Is only one individual auditor selecting the cases?*

☐ Yes ☐ No

17. *Are audit selected taxpayers notified in advance?*

☐ Yes ☐ No

18. *Does notification has impact?*

☐ Yes ☐ No

19. *If 'yes' negative or positive or both?* _____

20. *Could you state the significance or/and disadvantage of notification?*

21. *Is there any legal framework to see the taxpayers' record keeping?*

☐ Yes

☐ No

22. *If yes ,where can you see these record- keepings*

☐ *In the business premise*

☐ *Can be taken outside the business premise if needed*

23. *Do tax auditors have access to third party information sources?*

☐ Yes

☐ No

24. *Is there any access to obtain information from other national revenue bodies?*

☐ Yes

☐ No

25. *Are the tax payers cooperative to give essential information's?*

☐ Yes

☐ No

☐ *partially (not all)*

26. *For the above if the answer is "No" what could be the reason behind?*_____

27. *Do you think that you are performing the audit work as per GASP (Generally Auditing Standards Procedure)?*

☐ Yes

☐ No

☐ *Partially*

28. *Could you state the possible reasons for the answer given for question No.28?* _____

29. Which tax category of tax payers are more difficult to audit?

- ☐ Category A tax payers ☐ Category B tax payers
☐ Category C tax payers ☐ All categories

30. What would the possible measures (solutions) to solve the problem?

31. Is there any thing to add in relation to tax audit practice in Ethiopia?

Annex II		Summary of General Government Revenue by Component							
Particulars	1990	1991	1992	1993	1994	1995	1996	1997	1998
Total Revenue and Grants	9686.4	11215.2	11222.1	12805	14628	15,703	17,188	24,096	26,615
Total Revenue ¹	8443.1	9453.2	9498.4	10177	11506	11,149	13,186	19,531	22,883
1 Tax Revenue	5268.7	5591.6	6482.8	7440	8646	8,243	10,520	12,397	14,159
1.1. Direct Tax Revenue	1869.4	2008.8	2367.3	2735	3512	3,010	3,132	3,930	4,461
1.1.1 Income Taxes	1523	1680.4	1952.6	2143	2636	2,878	2,832	3,569	3,819
- Personal	433.6	505.2	593.9	686	794	833	948	1,132	1,414
- Business	1089.4	1175.2	1358.7	1457	1842	1,639	1,303	1,714	1,741
1.2 Rural Land Use Fee	97.8	108.4	111.5	117	127	406	581	723	665
1.3 Urban Land Use Fee	115.6	66.9	86.8	123	201	88	114	140	124
1.4 Others	133	153.1	216.4	352	548	44	186	221	517
2. Indirect Taxes	3399.3	3582.8	4115.5	4705	5134	5,233	7,388	8467	9698
2.1 Domestic Taxes	1180.8	1204.3	1439.7	1381	1830	1,668	2,112	2721	3111
2.2 Foreign Trade Taxes	2218.5	2378.5	2675.8	3324	3304	3,565	5,276	5746	6587
- Import	2037.2	2223.2	2527.6	3231	3252	3,564	5,276	5746	6587
- Export	181.3	155.3	148.2	93	52	1	0	3184	5371
3. Non-Tax Revenue	3144.4	3861.6	3015.6	2738	2860	2,906	2,666	7134	8724
3.1 Charges and Fees	130.7	176.6	200	179	298	252	321	1106	3136
3.2 Gov. Invt. Income	1400.2	1423	1183.5	1353	1249	1,102	1,250	193	310
3.3 Reimb. and Property Sales	92.2	91.8	474.6	203	217	204	185	856	433
3.4 Sales of Goods & Services	164.1	282.4	356.6	340	427	330	376	414	1113
3.5 Others	1357.2	1887.8	800.9	663	669	1,018	534	4565	3732
4. Grants	1273.3	1762.1	1724.1	2628	3122	4,554	4,002	4565	3732

%age shareof tax revenue to the tpal revenue	54.39	49.86	57.77	58.10	59.11	52.49	61.21	51.45	53.20
%AGE SHARE OF NON TAX TOTAL REVENUE	32.46	34.43	26.87	21.38	19.55	18.51	15.51	29.61	32.78
%age SHARE OFgrantTAX TOTAL REVENUE	13.15	15.71	15.36	20.52	21.34	29.00	23.28	18.95	14.02
	100.00	100.00	100.00	100.01	100.00	100.00	100.00	100.00	100.00

Annex III

